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MARKET AND DEMOCRACY:

FRIENDS OR FOES?

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**Market and Democracy:
Friends or Foes?**

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Market and Democracy: Friends or Foes?¹

The postmodern realities of the turn of the century make it next to impossible to formulate unambiguous causal relationships between individual phenomena. The more complex these are, the harder it is to prove the existence of causality as well as the working of the algorithms and mechanisms through which the cause-consequence relationship functions. In our case neither democracy nor the market can be taken as clearly defined concepts or categories, elementary facts that could easily fit into one of our econometric models. Thus it is unsurprising if their interrelationship counts among the evergreens of economic theory and political science alike, especially in the development context. The situation is further complicated by the complexities of postsocialist transformation, which presents a series of novel or partly novel theoretical and policy issues² that add to the challenge of Central- and East European developmental catchup and modernisation. It is in this peculiar context that the interrelationships between democracy and the market, both interpreted according to the classical liberal tradition³ is going to be scrutinized, with keeping an eye on the Russian/Baltic experiences in the 90s. As proper elaboration of the subject would require a monograph, I shall restrain the discussion to seven theses.

1. In the very first stage of systemic change, stabilization democracy and the market are clearly foes⁴. Stabilization, unlike institution building and developmental policies, constitutes a basically technical task that any government had to put in operation, irrespective of its broader deliberations. Why the currency reform of Ludwig Erhard in 1948 paved the way to the social market economy in Germany, the Hungarian stabilization of 1946, though arrested the highest inflation in economic history, meanwhile its technique paved the way to a gradual introduction of an autarkic command economy years before Communist takeover in 1949 (Ausch 1958). It has been a general experience in transforming countries that legislation, political parties, the press and local municipalities in their overwhelming majority rejected and resented the measures aimed at stabilization. In case of Russia attempts by the Gaidar government to stabilize in 1992 started to be watered down and later openly sabotaged by legislation and also by the central bank. The 1993 and 1995

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² For two partly contrasting interpretations of what way the peculiarity and novelty of this task may be seen of (Csaba 1995) and Wagener (1996).

³ This is not the place to discuss methodologies and possible alternatives to other conceivable interpretations of the basic notion (like Islamic democracy or socialist market). Following the universalist line of the UN Charter I shall take these as generally valid.

⁴ A contemporary account is presented by the various authors in Csaba ed. (1991).

elections produced legislative majorities clearly hostile to plans of disinflation. When from mid-1996 stabilization still materialized, it happened owing to the newly won legitimation of President Yeltsin as well as his government's ability and willingness to circumvent hostile legislation and disregard public opinion on economic issues. Forms of civil society, from local municipalities to members of the Academy of Sciences have been going out of their ways to turn this tendency around in 1991-97. Opinion polls show a steady 30-35 per cent of voters clearly favouring the free market economy as well as parties and formations supporting these ideas. Only countries with next to incontestable governmental authority succeeded in disinflation, like Poland in 1989-91, Croatia, Estonia, Slovenia, the Czech Republic and finally Russia. True, the causal relationship is not reversible: a strong authoritarian government may not be a sufficient condition for sustaining disinflation, as Kazakhstan and other Central Asian countries would testify. Whenever the government can be leveraged by competing social groups or by public opinion, moderate levels of inflation sustain, as in Poland since 1992, in Hungary, or in a different degree in Serbia-Montenegro, Turkey or Brazil.

2. Once inflation stabilization is mastered, transformation is likely to focus on the institutionalization of interests, on creating procedures and controls of decisionmaking, both in the economic and the political fields. Building up previously non-existent institutions, from constitutional courts to private pension funds comes to the fore. At this stage of development democracy and the market become friends (once stabilization has laid the groundwork). In setting new, lasting and workable arrangements representation and also articulation of conflicting interests is needed. The less the preoccupation of parties with attaining immediate gains, in other words, the smaller the influence of redistributory conditions is, the higher the functionality of the emerging arrangements. In concrete terms only in the latter case is it reasonable to expect that election cycles do not generate regular economic and legislative cycles, which, of course, destabilize democracy and its institutions. In sum, the more pure idealistic democratic considerations dominate in the elaboration of new rules against bread and butter issues, and corporatist considerations, the more stable institutional arrangements may emerge. The wider is the practice of buying out opponents, the higher is the probability of ending up with a monopolistic rent-seeking society with low equilibrium, low efficiency and high polarization of wealth and income, especially if the state remains weak (Leipold 1992). The above described development is clearly visible in the Russian case in the 1993-96 period.

In the process of institutionalization it is of paramount importance that the frame and rules in which the fight among competing claims can be waged emerged in a transparent and calculable manner. Institutions in the economy

abound, with the emergence of market infrastructure in such areas as trade in agricultural commodities, equity markets, commercial banking, venture capital funds, collateral financing and the like. The less public concerns are voiced and can be articulated at the time of setting up the regulatory frame for those, the higher is the probability of malfunctions and also of plain crime, as the collapse of the Baltic Bank in Latvia or the high criminalization of the Russian banking indicates.

In the political arena market relations require and promote the emergence of modern, cross-class parties in the place of old-fashioned ideological and/or regional or social group-representations. This is all the more important if the left-right-left-right moves of the political shuttle is considered part and parcel of normalcy, that does not necessarily lead to erratic zig-zag in the economic course. From this angle Polish, Slovene, Estonian, Hungarian and Russian developments look reassuring. As parties cannot be classified into those representing the winners versus those of the losers, democracy may stabilize even if the most colorful and intellectually stimulating figures of the early stages had to give way to more professional political administrators and workhorses. As Bronislaw Geremek (1996) put it aptly, democracy equals to the rule of the Grey, as procedures matter more than personalities - and this makes the liberal order safe and calculable for the individual.

3. If the market economy is seen as a spontaneous order (Hayek 1989) this means our considering it to be a self-learning system, setting the objectives for itself (rather than taking it extraneously from its environment in an unspecified fashion, as in neoclassical models). This means that in purely economic terms there is nobody among the outside agents (including polity) who could or should take over the jobs of generating objectives as well as the competing strategies. The more indeterminative "final" targets are, the more diverse the "trajectories" leading to their attainment, the more indispensable democracy is. And not only as an ingredient or as a customary fellow traveler to sound economic policies, but a fundamental constituent in the workings of the system as such. If trial and error is the *modus operandi* of the market order, pluralist democracy is the only appropriate frame in which this can survive, correct its errors while avoiding disintegration. This means that democratic controls are indispensable for full-blood market institutions to work.

Rule of law is taken as given by all economic theories. Advanced market institutions from banking to stabilized agricultural marketing orders all require and presuppose the rule of law. Should this maximum not be observed, transplantation of arrangements and techniques well proven in the OECD area, may produce perverse results or undesirable side-effects. Discretionary decision making has always been, by necessity, a hotbed for inefficiency, corruption,

favouratism and generation of situation rents. The weaker the state, the higher is the probability of these malfunctions. The CIS-countries have a particularly notorious historical heritage of rule by decree, a practice that has not been discontinued with the abolition of Communist one party rule. Much of the pathologies of privatization and bank behaviour, richly analyzed in the Russian and international daily press derive from the underdeveloped state of the rule of law, where corruption and crime pays better than observing the regulations⁵. The role of democracy and the related transparency requirement manifest themselves particularly strongly in the fiscal area. Here both the revenue and the expenditure sides, as well as the relationships among the various subsystems of general government expenditure, and not least, their relationships to the central bank require democratic controls. On the hand, no professionally sound policies are even technically conceivable without clear delineations and transparency of operations, regularly scrutinized by an outside watchdog (the supreme auditing commission) under the jurisdiction of the legislative. The latter, in turn, can be little more than a circus provided the relevant pieces of information on the above transactions, their breakdown and outcome is not regularly provided and disclosed in external audited reports, based on international accounting standards (GFS of IMF). The above listed requirements are also easier said than done. In the CIS countries, but also in some other transforming countries these single rules of thumb are not (fully) observed. As a consequence public debates are often economically irrelevant (due to their subjects, targets as information base) or conversely, reforms have side effects far exceeding the intentional effects. The rather spontaneous emergence of fiscal federalism in the Russian Federation may be a good example of this. On the other hand the public resistance to some of the more radical fiscal reform measures in the Czech Republic, Hungary, Poland and also Romania have to do with the lack of transparency and the resultant public misperceptions pertaining to the fundamental qualities of the pre-reform versus post-reform systems. The lower is the transparency thus also the democratic accountability of the public finance sector, the higher is the probability for lobbyist, rent-seeking and arbitrary decisions to pay off, and thus proliferate.

Democracy and the rule of law play indispensable roles in supporting entrepreneurial initiative as the major source of innovation and structural change. New start-ups and reorganizations make the way for competing strategies and the selection and clearing process ensuring the efficiency of the market. The less the government is concerned with ensuring the contestability of market, the greater are the dangers inherent in monopolistic practices, that pose a threat to freedom and efficiency alike. The better the competitive quantities of the market are preserved, the higher the efficiency and also the

⁵ In current Russian parlance a democrat means a thief, an incompetent or simply a dishonest person.

social gains are likely to be, including the creation of middle class (Fehl/ v. Delhaes eds. 1997).

A middle class in transforming societies may well be quite dissimilar to its look-alike in Northern or Western Europe. Still, the widespread procedure of self-sustaining and self-employing activities already vouch warranty against massive support to extremist movements. The rise and fall of V.V. Zhirinovsky and the ongoing marginalization of extremist forces all across the region is a direct indication of deep social changes. This is yet another way how economic, social and political changes emerge in a mutually supportive/synergetic fashion.

4. Local power is certainly an area where the interaction between democracy and the market is less than trivial. This issue is particularly relevant to large countries, like Russia. But also in Central Europe, following centuries-old traditions reinforced by the Scandinavian model, that served as a point of reference in 1989/90, municipalities have been granted far-reaching powers in terms of wealth, taxation and financing institutions (like hospitals, schools, public transportation and infrastructure maintenance).

Local power in transformation countries has had a bad name as a "conservative" (i.e. backward looking, status-quo oriented) force, and mostly rightly so. Enlightenment tended to be generated by and devoluted from the power centre. Under this angle the partly intentional, but largely spontaneous devolution of authority that has been particularly manifest in Russia is mostly seen as a setback for democracy. As demonstrated also by the 1996/97 elections to the post of provincial governors various non-reformist candidates tended to win with convincing majorities. Also in economic terms, the booming Moscow is in sharp contrast to most provincial centres, where new start-ups, foreign investments and the related networks, financial services and often elementary services and infrastructure is non-available. Devolution of taxation often implies not less, but more burden, more arbitrariness and less forthcoming attitude on the side of authorities. It is hardly by chance that the Council of Federation (the upper house) already twice rejected the tax code, which would streamline, enumerate and specify the sorts and rates of all taxes and public dues to be levied in the Russian federation.

The set of regional financial equalization and transfer schemes - *Finanzausgleich* - are particularly poorly developed. This might be a problem as developmental differences among various subjects of the Russian Federation were in the range of 1:13 (Ivanov 1997) which is longer than between Albania and Holland (the latter being roughly 1:10 at PPP), and as the source notes has disruptive effects. In fact, while central tax burden in 1996 was about 9 per cent

of GDP, in the same year the consolidated tax burden was 37 per cent, which leaves very little room for centralized regional redistribution. Meanwhile most local authorities tended to adopt a more restrictive, rather than a more liberal, approach to entrepreneurship than Moscow powers. This, of course, slows down supply response and enhances tensions.

There are, however, favourable elements in the devolution of authority from the point of democratization. Local power emerged in response to local crisis situations, i.e. the administrations had to act on their own, not waiting for central directions. This is a step towards local self-management - a goal that was promulgated by an 1995 law, but has a long way to go. Local management shortens the information chain, thus decreases losses and enhances efficiency of crisis management. Also control costs can be saved and the principal-agent problem is less acute than was the case in the traditional Soviet single factory model. In perspective local taxation may become more legitimate if people have better insights and leverage over the ways money is being spent. This is currently, as yet a potential, and a largely unused one. The interconnection between the public goods (provided or not provided locally) and public dues (collected or uncollected) will become more transparent for all agents. This, in time will improve tax consciousness and tax-paying morale. Current governmental efforts to free corporations from social tasks may also enhance responsibilities of the local governments and press them to (re)act. In a way, former lower levels of a central administration cannot escape the responsibilities (as well as the rights) stemming from the delegation of property and authority to them. While they are mostly poorly prepared to perform new tasks, multiparty elections and local civil society (including entrepreneurial interest) will surely push them towards improvement. Last but not least, US and Chinese experience indicates, that decentralized large countries tend to (re)act in a less militant and imperial fashion towards the outside world, than highly centralized states do. This feature was clearly visible with the newly emergent post-Soviet states from Sakha (Yakutia) to Tatarstan. By contrast, in areas where regional self-management was denied or made practically impossible, as in Chechnia or in Abkhazia, disruptive conflicts multiply.

5. Privatization is one of the core activities of systemic change. In this context the peculiarity of this operation rests with its unprecedented size and scope. Whereas in Western countries 5-10 per cent of national assets were passed over private hands, postsocialist countries faced a much larger task. In Hungary, e.g. in 1989 only 15 per cent of assets were private, while by end 1996 it grew to 75 per cent. In western economies available institutions, rules and macrodistribution of wealth hardly change by privatizations. Therefore winners are numerous (receptients of improved services), while losers are small in numbers (laid off employees). An Eastern privatization is just the opposite to

all these. Even in technical terms whereas in the West change of ownership is a way to find new management, in the East (de facto contrary to government-sponsored schemes) normally, as a rule, managers pick new owners. In sum, while quick and sound privatization has been a must, the social implication was inevitably controversial, distributionally non-neutral and losers were in large numbers. There are several ways how - the often missing - democratic controls may, and indeed should, remedy these ills.

Parliamentary democracy has the right and the possibility to introduce and enforce those controls, regulations and taxation that are necessary both for the equity and efficiency considerations and - in the end of the day - to ensure social acceptance as well the correction of market failures that burden this process. Again, technical/economic and broader political considerations overlap.

As far as controls are concerned, a public information act, prescribing disclosure commitments as well as the obligatory auditing of corporate balance sheets may be the best way to remedy most of the pathologies of the initial period. Restering of share ownership as well as transfers, keeping up to date registers of asset ownership, licensing financial intermediaries and checking their professional and moral credentials (including the blacklisting of managers having been involved in major failures and frauds) sound though trivial, but have a long way to go in most transforming countries. The same applies to international accounting standards that may bring qualitatively different results than soft and lax local traditions and practices. Enforcing the above listed controls would produce sounder management (i.e. more efficiency) while making the current early capitalist business sounder and also more transparent - for stock owners and the public alike. Under these circumstances reasonable tax rates could be set and collection of these dues were easier to administer, since costs of evasion would approach costs of orderly payment.

One of the obvious market failures has been the widespread practice of insider trading and the resultant general insider dominance in ownership structure and also monopolization. In some cases domestic public monopolies were turned into foreign - public or semipublic - monopolies during the privatization operation. Asset stripping could not, in many cases, be prevented even if it went at the cost of maximising corporate wealth (Bim 1996). Enforcing bankruptcy legislation is also a public task: lacking it the market will not clear and such irregularities, as retaining employees but not paying them for months, may survive. Also antitrust and environmental concerns call for regulation. In a way, much of what the public ascribes to private capitalism is a clear reflection of regulatory failure, which in some cases can go as far as a complete lack of any

regulation (as was the case with the Czech, Russian and Baltic equity markets in the initial period). This hurts efficiency and equity considerations alike.

The reform program of the Russian government adopted in May 1997 addresses some of the neuralgic points. The new emphasis on deconcentration, which seem to have hit the previously almighty Gazprom (Financial Times 17/18 May 1997), the first results on severing tax collection, as well as the severing of prudential and capital adequacy requirements have already accelerated concentration of banks (as a special way of crisis management), which all point to the right direction. This is reassuring even if empirical observations always highlight how long ways implementing reform ideas have yet to go - at times, against local power, at times against new private owners.

6. When it comes to the reform of the welfare state, democracy and the market seem to be obvious foes. Existing/inherited arrangements reflect a previous social contract, to which everybody used to be a signatory one way or another. Thus touching this issue by definition antagonises not only vested interests, but also the un(der)informed majority of laymen who feel threatened in their accustomed ways of life. Massive protests against minor cuts were the typical reaction all across Europe. Generalizing Hungarian experience the Harvard professor János Kornai (1995/96) has raised the question of limits to consensual decision making in this important area. But as Premier Juppé and Chancellor Kohl also had to experience, this problem is not restricted to transforming economies only.

It seems certain, that similarly to tax legislation, the bits and pieces of welfare reform cannot be put to referendum. However, democracy used to be called rule by persuasion by the 18th century whigs, which is precisely the only way-out from a potentially selfdamaging deadlock. People in transforming countries have shown a remarkable endurance of hardship, meanwhile not adopting those voting patterns as some political science theories, modeling them as economic animals, would have suggested. The Russian presidential elections as well as the Romanian parliamentary and presidential elections in 1996/97 were clear testimonies in this respect. Thus the way its welfare reform is bound to differ in genre, orchestration and implementation from stabilization: instead of a surgery homeopathic therapy is needed, with a very high input from psychology and other forms of non-financial motivation. Welfare reform will be protected and will succeed only if sound economics (taking stock of the international competition of localities) is combined with building up reform constituencies⁶ add a policy aimed at orchestrating widening support for these policies via open

⁶ On this point of Roland (1997)

public exchanges of views in the phase of elaborating reform concept and their implementation technologies and sequences.

Therefore it is probably reasonable to describe the connection between market reforms and democracy in this area as a delicate balance. French, Belgian, Italian and German experience point toward the dangers inherited in self-reproduction of out of date arrangements, that may lead to ossification, delays in and blockages of reforms, and finally a loss of competitive position, welfare and freedoms. On the other hand, lack of societal control and democratic participation may also be dangerous, as Russian and Ukrainian developments indicate. It spontaneous devolution, erosion and local self-defence dominate all central deliberations, the underprovision of public goods, services and functions will be chronic that, in turn, may reproduce the disruptive chains of prereform Latin American capitalism well known from Peru and Brazil. In the European context this may be destabilizing, especially for democratic arrangements but also in environmental, military and social terms, including health indicators. As a recent cross-country analysis of developing country and transformation experience (Buiter/ Lago/ Stern 1996) convincingly proves, successful market reforms require strong rather than idle governments, both in technical terms (institution building and regulation) and also as suppliers of services and opportunities, that make market outcomes socially acceptable. But in the long run, i.e. periods commensurate to the time required for rearranging the welfare state, only democratically legitimated, participating terms of governance are sustainable in the highly urbanized post-industrial societies across the globe. This applies a Fortiori in the present conditions of internationalization and of global informational society.

7. While the debate over the interrelationships between market and democracy would be hard to conclude, our previous reflections may be summarized as follows. Unlike in the 50s and 60s, the turn of the millenium is not forthcoming for ideas of developmental dictatorship. Globalization of financial markets, of information technologies⁷, of the flow of commodities, knowledge and people will though feel short of homogenizing mankind, however already palpably narrowed the scope for fundamentally dissimilar, non-complying and seclusive economic, social and cultural options alike. While until the 70s democracy tended to be seen as the privilege of advanced North and West European nations, by now several examples support the universal validity of these approaches. Following decades of centralized catch-up strategies such diverse countries as Spain, Korea, Chile and Taiwan all had to democratize. Mature economics and mature societies do require democratic pluralist forms of

⁷ Availability of e-mail connections and mobile phones thwarted sveral cover-up operations of war crimes recently in Bosnia and Chechnia, even if the feedback and the resultant political action was not imminent.

governance, irrespective of their cultural and historical heritage or geographical location.

These historical developments retroactively supply evidence to the theory of Walter Eucken (1952/1990) having established a structural interdependence between the political and the economic order. In the long run, only market systems are compatible with democracy, and only democratic governance is compatible with the market order. Interestingly, the areas that do not lend themselves to market reforms in advanced countries are the ones where practically no feedback and control mechanism constraints the activities of those operating the respective systems. From our perspective it is extremely important that Russia of the late 90s is quite unlike Russia of the 30s: it is not an agrarian society any longer, but a country where the share of services by 1995 exceeded the 50 per cent benchmark in GDP. References to the Russian soul or to history therefore are hardly overwhelming when the prospects of democracy are at issue. Fifty-five per cent of Russia's population live in big cities, and their voting patterns already reflect this, explaining the failure of the backward-looking coalition of inflation at the decisive point: in presidential elections. Fundamentals of economic advancement, such as innovation, new startups, the growing role of interfirm networks, internationalisation all require flexible and decentral decision making, which is the market. Meanwhile sustainability of sound policies, promoting supporting and correcting the underlying arrangements require a broad social consensus. The latter may emerge only from the democratic process of articulation and dovetailing conflicting interests. Stable and high level provision of the side conditions to these, including the security the adequate level of and fair availability in human capital accumulation, as well as public goods and regulation concerns require strong, but democratically accountable governments. These will probably be slim, rather than cheap, forms of administration, especially if corruption is to be rooted out.

The imperative of decentral decision making and plurality of options applies a fortiori for large, regionally diverse countries where a uniform straightjacket proves to be debilitating any time anyhow. From this perspective the spontaneous emergence of true federalism in Russia is a most encouraging sign, even if it is institutionalization covers primarily the legislative and executive branches. Completing this fact of life with open, transparent and regulated fiscal federalism would lay the ground work for sustaining democratization in Russia for a long time.

Abbreviations:

- CIS = Commonwealth of Independent States (all post-Soviet States less the Baltics)
- GDP = Gross Domestic Product
- GFS = Government Financial Statistics
- IMF = International Monetary Fund
- PPP = Purchasing Power Parity

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